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SENATE TAXATION 4

EXHIBIT NO.

2.9.11

SB 94

Memorandum

To: Senator Wittich, Senate Tax Committee
From: Lee Baerlocher, Bureau Chief
Date: February 7, 2011
Subject: Information Requests – Water's Edge Corporations

Following are responses to your information requests regarding water's edge corporations.

Question 1: Water's edge. What other states have an identical policy to that of Montana's?...or close to that of Montana's?

There are 23 states that use the combined reporting method with water's edge filing provisions. Montana's water's edge policies are generally in alignment with these states although there are variations in each.

Requiring the inclusion of 80/20 corporations in the water's edge group is one of the main changes proposed in SB 94. More than half of the 23 states employing combined reporting require the inclusion of 80/20 corporations in the water's edge group and have other provisions that are similar to what is being proposed by SB 94. Including 80/20 corporations in the water's edge group is even more common among other western states. SB 94 brings Montana into closer alignment with the majority of other combined reporting states on this issue – and especially with other western states.

It should be noted also that 80/20 corporations are included in a consolidated report for federal corporate tax purposes.

Although President Reagan's Secretary of the Treasury, Donald Regan, issued a major report in 1984 recommending that states include tax havens in water's edge combined reports, these provisions are a more recent trend in state law beginning in Montana in 2003. Two other states have since adopted tax haven provisions, and other states are considering such legislation. The Multistate Tax Commission, an interstate organization that assists states with multistate tax issues, has recommended such provisions as well.

Question 2: Water's edge. The level of revenue generated/lost during the past five years.

Unfortunately the Department cannot readily quantify the additional amount of taxes that would have been collected had Montana not allowed a water's edge election. To arrive at the tax lost, the Department would have to reconstruct each corporation's tax return on a worldwide basis and compare the results to the same corporation's returns filed on a water's edge basis. Even though the Department cannot specifically quantify that amount in a short period of time, in most cases, an election to file on a water's edge basis will serve to decrease a corporation's Montana tax liability.

Regardless of the amount of tax that would have been collected had there not been a water's edge election, it is important to remember that SB 94 is not intended to eliminate the water's edge election. SB 94 proposes to modify certain items of income that can be excluded or included in the computation of a corporation's Montana tax liability under the water's edge filing method. The fiscal note prepared for SB 94 estimates additional revenue of \$2.4 million per year related to these proposed changes.

The amount of revenue lost due to water's edge elections is most likely several times more than the \$2.4 million estimated in the fiscal note for SB 94.